DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 93-0962
Indiana Corporate Income Tax
For the Years 1989, 1990, and 1991

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ISSUES

I. Gross Income Tax – Income Derived From Computer Related Service Work.

Authority: IC § 6-2.1-1-2(a); IC § 6-2.1-2-2.

The taxpayer protests allocation of income attributable to an Indiana based customer.

II. Adjusted Gross Income Tax - Non-Business Income.

Authority: IC § 6-3-1-20; IC § 6-3-1-21; IC § 6-3-2-2(a); IC § 6-8.1-5-1(b); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30; 45 IAC 3.1-1-59(7); 45 IAC 3.1-1-61; May Dept. Stores v. Ind. Dept. of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001).

The taxpayer protests the imposition of adjusted gross income tax on dividend, interest, sale of stock, patent, rental, and partnership income.

III. Adjusted Gross Income Tax - Tax Addback.

Authority: IC § 6-3-1-3.5.

Taxpayer protests the addback of various state and local taxes.

IV. Adjusted Gross Income Tax – Foreign Source Dividends.

Authority: IC § 6-3-2-12.

Taxpayer protests the amount of expenses attributed to foreign dividends.

VI. Tax Administration – Ten Percent Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

The taxpayer protests assessment of the negligence penalty and requests that the Department exercise its discretion to abate the ten percent penalty.

STATEMENT OF FACTS

Taxpayer provides its customers information and technology services. Under certain circumstances, taxpayer sells or leases computer equipment in conjunction with the provision of those services. One of the subsidiary corporations conducted business in Indiana. That subsidiary's income was the subject of the audit.

I. Gross Income Tax – Income Derived from Computer Related Service Work.

DISCUSSION

Certain revenues attributed to taxpayer's Indiana subsidiary were not allocated based upon administrative functions performed outside Indiana. Taxpayer claims an adjustment for its general and administration and overhead expenses attributable to its out-of-state locations. IC § 6-2.1-1-2(a) defines "Gross Income" as:

> Except as previously provided in this article, "gross income" means *all the gross receipts* a taxpayer receives:
>
> (1) from trades, businesses, or commerce; . . .
> (4) from the performance of contracts; (*Emphasis added*)

None of the exceptions referenced in IC § 6-2.1-1-2 are applicable to the revenues at issue. IC § 6-2.1-2-2 states in relevant part:

> (a) An income tax, known as the gross income tax, is imposed upon the receipt of: . .
> .
>
> (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana.

The statute's definition and imposition of the Gross Income Tax does not consider overhead and operational expenses of the taxpayer as subject to allocation. The taxpayer's customers are paying for a service, which is performed in Indiana. No part of the service is performed out-of-state. Because the entire service is performed in Indiana, the entire income from the service is taxable.

FINDING

The taxpayer's appeal is respectfully denied.

II. Adjusted Gross Income Tax - Non-Business Income.

The taxpayer protests the classification of interest, sale of stock, patent, and rental income as business income. Taxpayer also protests the classification of partnership income as nonbusiness income. Inasmuch as these five issues all center on the classification of income as either business or nonbusiness, this discussion section will review the relevant statutes and regulations concerning Indiana's classification of income. An analysis specific to each of the five types of income at issue will follow.

Under Indiana law, corporate adjusted gross income derived from sources within Indiana is reported as either business or non-business income. IC § 6-3-2-2(a). Under IC § 6-3-1-20, business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations." Non-business income is defined in the negative and "means all income other than business income." IC § 6-3-1-21.

Regulation 45 IAC 3.1-1-29 defines business income as that "income from transactions and activity in the regular course of the taxpayer's trade or business including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business." That same regulation goes on to state that "[t]he classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'nonbusiness income' is identification of the transactions and activity which are the elements of particular trade or business." Id.

45 IAC 3.1-1-30 interprets trade or business activity as including:

> Whether An Activity Is A "Trade or Business". For purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression "trade or business" is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business and derive business therefrom depending upon but not limited to some or all of the following:
>
> (1) The nature of the taxpayer's trade or business.

(2) The substantiality of the income derived from activities and transactions and the percentage that income is of the taxpayer's total income for a given tax period.
(3) The frequency, number, or continuity of the activities and transactions involved.
(4) The taxpayer's purpose in acquiring and holding the property producing income.

In determining the nature of income, states have employed one of two tests based upon the previous language. The regulatory phrase, "income from transactions and activity in the regular course of the taxpayer's trade or business . . ." has led to the formulation of the "transactional test." Id. Under this test, the nature of the particular transaction is critical in determining the nature of the income in question. The second test is the "functional test" and is derived from the language which states that "income from tangible and intangible property [represents business income] if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business." Id. In this second test, the particular use or function of the asset -- to which the income at issue is attributable -- within the taxpayer's regular trade or business is used to categorize the income as either business or nonbusiness. *See* May Dept. Stores v. Ind. Dept. of State Revenue, 749 N.E.2d 651, 662-63 (Ind. Tax Ct. 2001).

Sale of Stock: Taxpayer received shares of stock for assets transferred as part of the creation of a subsidiary corporation from a division of taxpayer corporation. The former corporate division was operating in Indiana both prior to and after the stock transfer. The formation of the subsidiary was intended to facilitate the sale of this segment of the taxpayer's business. The stock was subsequently sold in various transactions taking place from 1988 through 1990. Under the "functional test," business income includes "income from tangible and intangible property if the acquisition management, or disposition of the property are integral parts of the taxpayer's regular trade or business." The essence of stock sale implicated the sale of taxpayer's subsidiary and income derived is properly classified as "business income."

Investment Interest: Taxpayer argues that certain interest income represents nonbusiness income. To that end, taxpayer has presented what is purported to be "representative documentation with respect to that interest income." Taxpayer concludes that – with the exception of 10 percent of the interest income which is admittedly business income – this "representative documentation" is sufficient to support a conclusion that the remaining 90 percent is properly classified as nonbusiness income. Taxpayer errs in its conclusion. At the time of the original audit, taxpayer represented that it employed excess cash derived from government contracts to invest in short and long term investments consisting of preferred stocks, bonds, and long term certificates of deposit. Taxpayer declined the opportunity to provide any details concerning those investments except for two sheets of paper summarizing – within some seven lines of text – the source and disposition of some 20 million dollars in investment income. Taxpayer may not during the administrative appeal stage overcome the presumption of correctness – afforded by virtue of IC § 6-8.1-5-1(b) – attached to the audit's initial assessment by means of self-selected "various representative documentation" which it chose to provide subsequent to the audit. The taxpayer has failed to meet it burden of proof, mandated under IC § 6-8.1-5-1(b), necessary to refute the conclusion that the interest

income at issue represents business income.

Patent Income: Taxpayer received income attributable to its ownership of a patent. The patent came into taxpayer's possession when it acquired the company that originally owned the patent. Along with the patent itself, taxpayer also acquired a pre-existing licensing agreement which enabled an unrelated entity to exploit the patent. The patented item is an "adapter" fixture, a hardware item – in itself – unrelated to taxpayer's business of providing information and technology services.

45 IAC 3.1-1-61 provides guidance in classifying patent income as either business or nonbusiness income.

> Parent and Copyright Royalties. Parent and copyright royalties are nonbusiness income if the patent or copyright with respect to which the royalties were received did not arise out of or was not created in the regular course of the taxpayer's trade or business operations or where the purpose of acquiring and holding the patent or copyright is not related to or incidental to such trade or business operations.

In addition, the regulation provides a two-part example to explain the distinction between business and nonbusiness patent and copyright income.

> The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquired the assets of a small publishing company, including music copyrights. Their acquired copyrights are therefore used by the taxpayer in its business. Any royalties received on these copyrights are *business income*.
>
> Same as last example, except that the acquired company also held the patent on a type of phonograph needle. The taxpayer does not manufacture or sell phonographs or phonograph equipment. Any royalties received on the patent would be *nonbusiness income.* 45 IAC 3.1-1-61(2), (3). (*Emphasis added*).

Taxpayer's ownership of the patent was merely the tangential result of the taxpayer's purchase of the acquired company; the income attributable to the patent was derived as a result of a pre-existing licensing agreement between the acquired company and the third-party licensee; the parented hardware item was only superficially relevant to the taxpayer's service business. The income, derivative of the taxpayer's ownership of the adapter patent, is analogous to the phonograph needle patent income described in the second half of the regulatory example set out in 45 IAC 3.1-1-61(2), (3). Accordingly, the income attributable to the patent was not derived during the "regular course of the taxpayer's trade or business," and the income is properly classified as "nonbusiness income."

Rental Income: The auditor found that the rental property was previously used by the taxpayer for business operations. As taxpayer's protest stated, the rental property "is, or has been converted to investment property." IC § 6-3-1-20 states that "business income" includes "income from tangible and intangible property, if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operation."

Accordingly, the rental income falls squarely within the definition of "business income" as defined by the "transactional test."

Partnership Income: The audit took the position that taxpayer's partnership income should be classified as nonbusiness income because taxpayer owned less than 20 percent of the participating partners. In its protest, taxpayer disagreed arguing that the partnership income should be classified as business income.

Taxpayer entered into joint-enterprise agreements with its partners to perform management and administrative services at two government owned facilities. The contract agreements to perform these services were bid and awarded through the joint efforts of taxpayer together with its partners. The contract agreements related to the provision of services which taxpayer had previously performed for the government on its own behalf. Under the contract agreements, the services were performed, wholly or in large part, by taxpayer's own employees and management staff. According to taxpayer, the primary difference the partnership agreements and agreements under which taxpayer was the sole performer, was that the partnership agreements allowed for the apportionment of the resulting income between the coventurers.

While it is undisputed that the taxpayer owned less than 20 percent of the participating partners, the Department looks to whether the "income [arose] from transactions and activity in the regular course of the taxpayer's trade or business." IC § 6-3-1-20.

Taxpayer is in the business of providing management consulting, education, and research programs related to the strategic use of information resources. In addition, taxpayer is in the business of designing, integrating, and implementing computer resources to manage those information resources. Taxpayer's joint enterprise agreements involved the provision of services similar to the services taxpayer independently provides. The joint enterprise agreements were effectuated largely by taxpayer's own employees and management staff. The joint enterprise agreements with the government were similar to agreements taxpayer previously entered into with the government.

Accordingly, within the limitations of the "transactional test," and within the limitations of the regulatory language in effect at the time the assessment was proposed, the consequent income should be classified as business income. The income derived from taxpayer's joint enterprises was essentially a mirror image of the income taxpayer derived within the normal and regular course of its business. The joint enterprise agreement activities giving rise to the income were similar – if not identical – to the activities taxpayer performed outside the joint enterprise activities.

FINDING

The taxpayer's appeal is sustained as to classifying partnership income as business income and classifying patent income as nonbusiness income. Taxpayer's protest is respectfully denied as to reclassifying rental, interest, and sale of stock income. That income will remain classified as business income.

III. Adjusted Gross Income Tax - Tax Addback.

Taxpayer protests the addback of various state and local taxes under the provisions IC § 6-3-1-3.5(b)(3) which requires the addition to Indiana Adjusted Gross Income of "any deduction or deductions allowed or allowable pursuant to Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States."

Taxpayer is correct in its assertion that municipal taxes are not subject to the addback provisions set out in IC § 6-3-1-3.5(b)(3). However, taxpayer errs in its analysis of the Washington Business and Occupation Tax. Taxpayer contends that the Washington Business and Occupation Tax is a gross receipts tax that does not need to be added back. As taxpayer maintains, the Washington Business and Occupation Tax may be labeled a tax "upon gross receipts and not net income." However, the tax is nonetheless *measured* by income. IC § 6-3-1-3.5(b)(3) specifically states that taxes measured by income must be added back for Indiana Adjusted Gross Income Tax purposes. The fact that that the Washington Business and Occupation Tax is not labeled as an "income tax" does not alter the fact that the tax is measured by income and must be added back.

FINDING

Taxpayer's protest is sustained as to the municipal tax issues and respectfully denied as to the Washington Business and Occupation Tax issue.

IV. Adjusted Gross Income Tax – Foreign Source Dividends.

In calculating its Indiana tax liabilities, taxpayer, pursuant to IC § 6-3-2-12, deducted foreign source dividend income from its Indiana adjusted gross income. Audit, however, disagreed with taxpayer's calculus. Re-calculation by audit resulted in an increase in taxpayer's Indiana adjusted gross income and tax. Proposed assessments of Indiana adjusted gross income tax followed.

IC § 6-3-2-12(b) states that "A corporation that includes any foreign source dividend in its adjusted gross income for a taxable year is entitled to a deduction from that adjusted gross income. (1) The amount of the deduction equals the product of the amount of the foreign source dividend included in the corporation's adjusted gross income for the taxable year; multiplied by (2) the percentage prescribed in subsection (c), (d), or (e), as the case may be."

The aforementioned subsections (c), (d), and (e) allow corporate taxpayers to receive a one hundred percent (100 %) deduction for foreign source dividends received from corporations in which a taxpayer has an eighty percent (80 %) or larger ownership interest; an eighty-five percent (85 %) deduction for dividends received from corporations in which a taxpayer has a fifty to seventy-nine percent (50 % to 79 %) ownership interest; and a fifty percent (50 %) deduction for dividends received from corporations in which the taxpayer has less than a fifty percent (50 %) ownership interest. IC § 6-3-2-12(c) to (e).

The statutory language is straightforward. IC § 6-3-2-12 authorizes pro rata deductions (based upon the percentage ownership of the payor by the payee) of certain foreign source dividend income.

FINDING

Taxpayer's protest is sustained.

V. Tax Administration – Ten Percent Negligence Penalty.

DISCUSSION

The taxpayer protests the Department's imposition of the ten percent penalty assessment. IC § 6-8.1-10-2.1 requires that a ten percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Department regulation 45 IAC 15-11-2 provides guidance in determining if the taxpayer was negligent.

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrated that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . ."

In this instance, the taxpayer has demonstrated the requisite "reasonable cause." The taxpayer has provided to the Department's satisfaction, sufficient justification for its interpretation of the corporate income tax code provisions.

FINDING

The taxpayer's protest is sustained.

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